EARNINGS MANAGEMENT OF SEASONED EQUITY OFFERINGS IN SOUTH AFRICAN LISTED FIRMS

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ABSTRACT

The quest for additional capital by corporates is a continuous undertaking as firms seek to expand their scope of operations and maximize shareholder value. This is the primary reason why firms engage in seasoned equity offerings (SEOs). However, managers are under constant expectations by various firm stakeholders to produce attractive financial results. This compels them to engage in earnings management. Earning management refers to the practice of applying various accounting techniques and practices that present an overly optimistic view of the financial statements. This study involves examination of SEOs issued in South African listed firms at the JSE for an 8 year duration between the year 2008 and 2018. The study relies on panel data. The modified Jones model is employed to measure discretionary accruals which are a useful proxy for earnings management in SEOs issuing firms. Based on prior evidence in empirical literature, it is envisaged that results will reveal firms issuing SEOs at the JSE engage in earnings management to make their stock more attractive to potential investors. This study contributes to theory and practice through shedding information on management activities that may influence the value of a security. Ideally, underlying fundamentals should be the key determinant of a securities value. If earnings management practices are involved, it is prudent for potential investors to be aware so that they can exercise informed investor judgement.

Key words: Earning management; seasoned equity offerings (SEOs)

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1.0 Background and Motivation
2.0

There is an ongoing concern that managers are engaging in earnings management when trying to raise additional capital through SEOs. The US capital markets regulatory authority, the Securities Exchange Commission (SEC), in the last decade shifted the spotlight on earnings management alluding to the emerging notion that the practice is pervasive, yet it remains an unchallenged custom[2]. Gunny (2010:855) breaks down earnings management into two major divisions; accruals management and real activities manipulation. The study further enunciates that accruals management occurs within the framework of generally accepted accounting principles (GAAP) and it involves the management trying to shroud and conceal the true firm's financial performance. Cohen, Dey, and Lys (2008:757) and Gunny (2010:855) posit that real earnings management occurs when managers surreptitiously carry out actions that change the structure and timing of a financing transaction, investment or an operation in a deliberate effort to influence the content of the financial statements.

The prevailing assertion that earnings management is prevalent and even convictions have been made because of engaging in it, is further confirmed in (Ball 2013:2). Under ordinary circumstances, managers are always seeking ways to present favorable statements that are acceptable to interested parties. Financial statements form the basis of evaluation on whether managers are fulfilling the cardinal goal of maximizing their shareholders wealth. Yoon and Miller (2002:58) succinctly state that earnings management occurs when managers duly exercise their discretion and personal judgment in preparing financial reports, structuring transactions, recognition of income, accrued expenses and receivables.

This study therefore embarks on establishing the exact nature of the nexus between earnings management and SEOs with particular attention to African financial markets. In addition, there is be an investigation on various earnings management techniques and their influence on SEOs a short time prior and post issuance of the SEO within the same market.

2.0 Literature Review
2.1 Relevance of Earnings Management

In their quest to maximize profit and shareholder value, managers may be inclined to engage in earnings management practices. Earning management refers to the practice of applying various accounting techniques and practices that present an overly optimistic view of the financial statements. The primary motivation for engaging in earning management is to influence investors' judgement based on the earnings managed in the financial reports. Various definitions have been put forward to decipher earnings management. Iatridis and Kadorinis, (2009:164) describes earnings management as the use of discretionary accounting accruals by the firm's management to alter reported earnings. The practice is inspired by market bias towards firms that show favourable earnings. Yaping (2005:33) defines earning management as the purposive accounting measures taken by management to bring reported earnings to a desired level through exercising their discretion as accorded to them by prevailing corporate laws and financial reporting standards. Silva et al., (2014:270) describes earnings management as the employment of legally permitted accounting discretion by managers, in the selection practices of recognition and measurement of accounting elements, to deliberately manipulate earnings.

2.2 Earnings Management around SEOs

[2] Remarks made by Arthur Levitt, Chairman of the Securities Exchange Commission on September 1998

Prior research unveils evidence of earnings management practices around SEOs. Some studies attempt to explain the poor stock price characterized by SEO issuing firms after the post offering period while others investigate the managers' motives for engaging in earnings management around SEOs. Yoon and Miller (2002:57) investigate 249 Korean SEOs issuing firms during a 3 year period from the year 1995 and 1997 to determine if these firms manage their earnings in the year before a planned issue of seasoned equity stocks. The authors rely on accrual difference, correlation and sign change as tests methods to investigate whether the SEO sample differs systematically in earnings management from the control samples. Discretionary accruals is relied upon as a proxy for earnings management. Evidence reveals that Korean firms contemplating SEOs in the following year do manage earnings particularly when their relative financial performance has been poor. Further analysis of firms operating performances around SEOs revealed that SEOs issuing firms are more likely to manage earnings if the operating performances are poor or if the offer sizes are relatively large. It can therefore be inferred that SEOs issuing firms opportunistically alter their discretionary accruals which amounts to earnings management.

2.3 Earnings Management and SEO Stock Price Performance

The poor stock price performance of firms that raise capital through SEOs is considered to be one of the most important anomalies of the financial markets. This has cast the spotlight on the role of earnings management in influencing the performance of SEOs. The presence of abnormally large discretionary accruals around SEOs can be relied upon to infer that these firms opportunistically manage their earnings upward to temporarily boost their stock prices. Existing studies reveal that earnings management negatively impacts on the performance of SEOs. Rangan (1998:101) examines whether earnings management around the time of the offering can explain a portion of the poor performance of firms subsequent to an SEO. More specifically, the author investigates whether investors' inability to unravel earnings management around the time of the offering can explain the subsequent poor stock price performance. The earnings management measure is derived from current accruals, a non-cash component of net income. Evidence reveals that discretionary accounting accruals in the period surrounding the offering predicts a portion of the subsequent poor earnings and stock price performance. The author establishes that a portion of the discretionary accruals can be used to infer deliberate earnings management and thus SEOs issuing firms manipulate their stock price by managing earnings.

2.4 Empirical Literature Review in Selected Emerging Markets

Emerging markets have attracted global investor attention and acquired new significance in the last two decades. Many international investors are realizing that they can generate more returns in emerging markets compared to mature markets albeit at a higher risk of liquidity and volatility of exchange rates. Emerging markets are those considered to be in transitory phase between the developing phase and attaining a fully developed status. These markets have become the emerging frontier in terms of stock offers as new firms continuously issue both IPOs and SEOs at an increasingly higher rate to finance their growth (Sechel, Ioana-Cristina, Gheorghe, 2014:40). The main feature that makes emerging markets attractive remains the capacity to provide investors with an opportunity to realize higher profits more than in the developed mature markets.

There limited prior studies undertaken showing the relationship between earnings management, SEOs and firm performance in the emerging markets. Available literature suggests that a majority of the studies have been carried out in the traditional developed Western markets such as the US, Japan, Australia and Europe as well as the newly developed or emerging markets such as China, Malaysia, Singapore, Taiwan, Brazil and South Korea. A few studies have dwelt on earnings management separately from SEOs and firm performance on the other hand. A sample of these studies are reviewed in the following subsection.

Literature available shows a paucity of research output on earnings management and SEOs in the emerging markets. Vladu and Cuzdriorean (2014:695) analyse prior research emanating globally from accounting journals which has covered the area of earning management detection (EMD). The period of study covered a 10 year duration between 2003 and 2013. Evidence on the authorship and location of EMD research globally indicates that a greater majority of the studies have been undertaken in the developed markets of US, China, Canada, Australia, Japan and the UK. According to the authors, these countries approximately account to 95% of the research output on EMD globally. This points out to a marked scarce of research output on EMD in the emerging markets and more specifically in Africa.

3 Hypothesis Statement

Hypothesis one seeks to examine the extent of earnings management in SEOs issuing firms and its impact on firm performance. This study hypothesizes that EM is present in SEOs issuing firms than non-issuing firms in African securities market and consequently, it is important to unearth the extent of EM in SEOs and its influence on firm performance.

Prior studies have shed light on the existence of EM in SEOs issuing firms as stated in hypothesis one. However, hypothesis one is grounded on the reasoning that, apart from determining the existence of EM in SEOs, it is also imperative to determine the extent of EM in SEOs issuing firms. The extent or degree of EM in SEOs is important in establishing whether EM materially affects the content of the financial report in an attempt by managers to induce investors to participate in SEOs.

Hypothesis one is formulated to shed light on the following question, what is the extent or pervasiveness of EM in SEOs issuing firms in African securities markets? The hypothesis is expressed as follows with regards to African securities markets:

H_0 = *In South African listed firms, SEOs issuing firms do not experience statistically significant levels of EM.*

H_α = *In South African listed firms, SEOs issuing firms experience statistically significant levels of EM.*

4 Data and Methodology

4.1 Data

Following closely the sample selection methods adopted by Das et al., (2017:164) the sample for this data consists of 196 SEOs in SA, issued between 2008 and 2017. There are no limitation on the size of the SEO deal to be selected. The data is picked from the Bloomberg Financial Database.

4.2 Methodology

This study relies on the modified Jones model (2005) model. Extra modification variables such as ROA are included as appropriate to make the model more robust for testing the stated hypotheses (Silva et al., 2014:273). The model for measuring discretionary accruals is expressed as follows in equation (6.7c) and (6.7d) in tandem with (Kim and Sohn, 2013:19).

$$\frac{TAC_{ijt}}{A_{ij,t-1}} = \beta_0 + \beta_1\left(\frac{1}{A_{t-1}}\right) + \beta_2\left(\frac{\Delta SALES_{ijt}}{A_{t-1}}\right) + \beta_3\left(\frac{PPE_{ijt}}{A_{t-1}}\right) + \beta_3\left(ROA_{ijt}\right) + \varepsilon_{ijt}$$

(6.7c)

Equation (6.7c) depicts the relationship between total accruals and the values used to compute it for firm *i,* country *j* at time *t*. The equation is estimated cross-sectionally. *TAC* denotes total accruals, symbol *A* represents total assets, $\Delta Sales$ represents change in sales or revenues, ΔPPE represents change in gross property, plant and equipment, *ROA* is return on assets while ε is the error term. TAC is computed as shown in equation (6.7d).

$$TAC_{ijt} = EBIT_{ijt} - CFO_{ijt}$$

(6.7d)

Equation (6.7d) depicts the computation of TAC for firm *i*, country *j* at time *t*. $EBIT_{ijt}$ represents earnings before interest and taxes while CFO_{ijt} is cash flow from operations which is extracted directly from statement of cash flows. The estimated parameters in equation (6.7c) are used to compute non-discretionary accruals (NDAs) in equation (6.7e).

$$\frac{TAC_{ijt}}{A_{ijt-1}} = \hat{\beta}_0 + \hat{\beta}_1\left(\frac{1}{A_{ij,t-1}}\right) + \hat{\beta}_2\left(\frac{\Delta SALES_{ijt} - \Delta REC_{ijt}}{A_{ij,t-1}}\right) + \hat{\beta}_3\left(\frac{PPE_{ijt}}{A_{ij,t-1}}\right) + \hat{\beta}_4\left(ROA_{ijt}\right) + \varepsilon_{ijt}$$

(6.7e)

In equation (6.7e) $\Delta Sales$ is adjusted by ΔRec (change in receivables) to take into account earnings management in revenues. The other variables remain the same as those depicted in equation (6.7c).

5.0 Results

5.1 Descriptive Statistics

Table 1

Year	Total Assets ($ Mil.)	Market Capitalization ($ Mil.)	Offer Size ($ Mil.)
2008	123 663.91	146 870.87	2 860.39
2009	135 579.41	133 302.16	1 546.70
2010	146 853.75	169 377.63	2 808.25
2011	170 584.69	182 764.02	363.30
2012	168 652.43	211 394.08	3 476.14
2013	163 497.84	212 776.74	1 072.95
2014	170 073.27	236 995.24	6 238.29
2015	160 377.77	196 117.42	6 036.67
2016	155 616.23	198 027.03	5 048.67
2017	180 744.67	222 590.02	2 029.35
2018	177 788.41	247 287.08	1 546.25

Source: Author's Computation

Table 1 summarizes the essential firms issuing SEOs characteristics. The table reveals that market capitalization is far high than the total assets depicting that SEOs issuing firms are growth companies seeking additional funds for expansion.

Table 2

Year	No of SEOs	Freq (%)	Cum Freq %
2008	14	7.14%	7.14%
2009	14	7.14%	14.29%
2010	28	14.29%	28.57%
2011	10	5.10%	33.67%
2012	13	6.63%	40.31%
2013	13	6.63%	46.94%
2014	26	13.27%	60.20%
2015	22	11.22%	71.43%
2016	20	10.20%	81.63%
2017	17	8.67%	90.31%
2018	19	9.69%	100.00%

Source: Author's Computation

Table 2 summarizes the number of SEOs issued between 2008 and 2018. There is a gradual increase in the number of SEOs raised between 2008 and 2014 before a downward trend begins in 2015 with a slight improvement in 2018.

5.2 Empirical Statistics

Table 3

		Discretionary Accruals			
	Observations	Mean (%)	Max (%)	Min (%)	Std Dev
Industry					
Capital Goods	10	0.538	5.64	-5.64	4.14029
Commercial Services	19	11.03	4.72	-28.85	17.58432
Communication Services	2	-1.498	24.59	-2.53	19.17674
Consumer Goods	22	-0.032	32.52	-9.12	10.08458
Consumer Services	9	-1.498	11.53	-11.98	6.88516
Energy	11	-0.112	77.54	-17.1	27.08428
Healthcare	16	22.638	336.4	-38.88	99.50556
Industrials	2	1.71	8.85	-5.43	10.09748
Materials	12	115.32	596.117	0.0408	24.96430
Media and Entertainment	2	-0.79	2.33	-1.58	4.41235
Mining	29	-3.52	6.27	-18.66	6.99210
Personal Goods	8	3.01	10.12	-1.61	6.24687
Retailers	25	2.15	17.96	-2.89	6.18599
Technology Equipment	10	-0.24	10.85	-11.07	8.46218
Telecommunication Services	4	-0.88	5.14	-5.44	4.40899
Transportation	2	-0.87	-0.87	-0.87	4.40899

Source: Author's Computation

Table 3 summarizes the proxy for earnings management (discretionary accruals) for the period under the study. A positive mean depict income increasing accruals and vice versa. Firms in the materials, healthcare and commercial services lead in the mean number of accruals followed by other sectors.

6.0 Conclusions

The data reveals that South African firms issuing SEOs manage their earnings as envisaged by literature. However, the relatively smaller number of SEOs issued in the country makes it more challenging to draw thoroughly conclusive inference on the extent of earnings management.

6.1 Suggestion for Further Research

Additional studies may need to be carried out on motivations for earning management as well as the short term and long term effect of EM on SEOs issuing firms financial performance.

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